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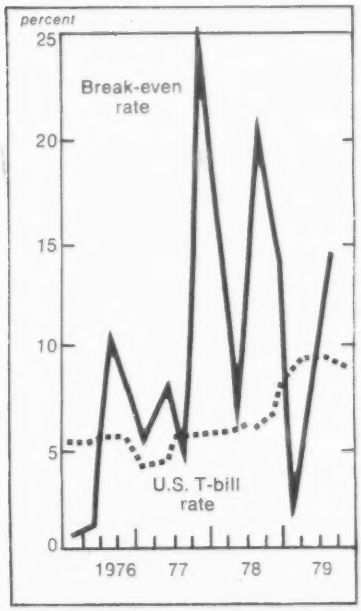
The Dollar Substitution Account

The finance ministers of the five major economies have announced their agreement in principle to the concept of a Substitution Account. Under this arrangement, central banks would deposit U.S. dollar instruments in a special account within the IMF and receive in return an SDR-denominated obligation. The dollars deposited in the Account would then be transferred into some form of U.S. government obligation. Proponents of this idea see it as both working to reduce the potential instability of exchange rates and enhancing the role of the SDR as a reserve asset.

This agreement does not extend to the specific details of the Account, however. Substantial differences of opinion remain as to what is an appropriate yield on the SDR-denominated claims against the Account, what sort of mechanism is appropriate to guarantee the salability of these claims at a price close to par, and what arrangements are appropriate for guaranteeing the preservation of the capital value of these claims. These questions are closely interrelated. If the yield on claims against the Account were set at "market rates," there would be less difficulty in guaranteeing their liquidity but greater difficulty in achieving agreement on how to ensure the Account sufficient funds to pay the interest due on those claims. If the yield were set at the current rate paid on SDRs—80% of the "market rate"—the latter problem is eased somewhat; however, the relative attractiveness of the asset would be reduced and a supplementary mechanism would be needed to guarantee its liquidity.

These details are particularly important to the United States because they define the potential interest cost on those U.S. government obligations held by the Account. The adjacent chart shows what dollar interest rates would have had to be paid to the Account over the past four years if the United States had agreed to assume *all* of the exchange risk involved in guaranteeing the ability of the Account to pay a *full* market SDR rate on its own obligations. This "break-even" rate would have averaged 3% higher than the actual rate on Treasury bills, roughly the same as the average annual rate of depreciation of the dollar against the SDR over that period. With this in mind, the United States has argued that any exchange risk associated with the Account should be shared broadly. Other countries have objected to this position, pointing out that an agreement to share exchange risks means that the claims issued by the Account would have very different characteristics from those of the SDR itself. The establishment of the Account would appear to hinge on the resolution of this conflict.

"Break-even" dollar interest rates* for a Dollar Substitution Account vs. U.S. T-bill rates, 1976-79



*Dollar interest rates needed to generate enough SDRs to cover the interest costs of the Account whose SDR interest rate is set at the "full market rate" (a weighted-average rate on T-bills or other short-term government obligations of the five major economies).

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Heavy speculative pressures prompt a German mark revaluation.

The recent adjustments in European Monetary System (EMS) parities—a 2% DM revaluation and a 3% Danish kroner devaluation—followed a period of intense speculative activity. A review of the EMS had been scheduled for September, and although a parity change was not justified by inflation differentials or current-account balances, foreign-exchange market participants had little to lose by moving into German marks for a limited period. The resultant speculative inflows into DM forced Germany to choose between either revaluing or absorbing large amounts of foreign exchange, which would have expanded the German money stock, lowered short-term rates, and further increased bank loans—all counter to the Bundesbank's strong anti-inflation stance. With no further parity changes likely to occur in 1979, a convergence of short-term rates can be expected. Germany still has room to raise rates somewhat higher, while short-term rates in weaker EMS-member countries are expected to decline relative to German rates because of the near-term reduction of foreign-exchange risk versus the DM.

Swedish economic downturn gathering momentum.

Sweden's new government now faces the prospect of an economic setback after two years of progress, with little political consensus as to what direction the country should take. The rise in oil prices together with the end of a rundown of import inventories threatens a sharp deterioration in the current-account balance. The 1978 deficit of kr. 4.4 billion is expected to widen to at least kr. 8 billion this year—and possibility to as high as kr. 13 billion. Additional foreign borrowings will probably be necessary to finance the expanding deficit, and interest rates will very likely be raised to encourage capital inflows. Looking to the longer term, the recent acceleration in Sweden's rate of inflation—consumer prices are now up 8.3%, year-on-year, versus 5.9% in January—threatens to erode export competitiveness and hinder efforts to reduce the balance-of-payments deficit. Furthermore, labor market conditions point to a renewed bout of wage drift that will complicate the November negotiations on a new national wage settlement.

Brisk Yugoslav growth spurred by investment boom.

Yugoslavia's economic performance has trended upward since 1976, paced by rapid industrial growth. The industrial growth rate was 9% for the first half of 1979, a level which has been sustained for nearly two years. The major stimulus to the economy has been capital investment, which grew more than 15% in real terms during 1978 and is growing at a 10% rate this year. The strong domestic demand, however, has boosted industrial prices and nominal incomes, raising the cost of living more than 12½% in the first half of 1979. On the trade front, surging imports pushed the trade deficit above $3 billion in the first half of the year, with a deficit of $5½ billion likely for the full year. As a result, financing of investment has now been restricted, and a 60-day price freeze was imposed in early August. Thus, Yugoslav growth rates are expected to decline during the last half of 1979, with a GDP growth rate of 6.5% expected for the full year. The slowing trend is expected to continue through next year, with moderate GDP growth of 4%-5% anticipated for 1980.

Brazil: optimism despite high inflation.

The tenor of business opinion in Brazil is generally optimistic, despite indications of imbalances in the economy. The rate of inflation in August, for example, reached 5.8%, the highest monthly advance since 1964. Assuming only moderate increases through year-end, the inflation rate would reach 60% by December. Also, higher oil imports are swelling the current-account deficit, which could reach $9 billion in 1979, compared with $5.9 billion last year. At the same time, debt service and outstanding debt are reaching new highs. Still, Brazil's access to international finance remains unimpaired, and domestic businesses share the positive attitude. Under the new Planning Minister, Delfim Netto, Brazilian policy has shifted from demand-restriction to supply-expansion as the basic means of combatting inflation. The intention is to lower the rate of inflation gradually over the next year or two with the hope that industrial and agricultural export growth rates are strong enough to reverse the disturbing trend of expanding current-account deficits.

Double revaluation for Austrian schilling.

Responding to accelerating inflation, Austrian authorities revalued the schilling against the DM by 1.5% in early September. When the DM was subsequently revalued by 2% within the European Monetary System (EMS), the schilling maintained its parity with the German currency, thereby resulting in a total schilling revaluation of some 3.5% vis-à-vis all other EMS currencies except the Danish kroner. At the same time, the Central Bank tightened credit by effectively raising the discount rate; although the official discount rate remains at 3.5%, banks must now pay 5.5% for central bank discounts beyond 70% of their discount ceilings. This split rate is estimated to have raised the average discount rate to 4.1%. The schilling revaluations should reduce inflationary pressure immediately, stabilizing the inflation rate at the current 4%, but the higher interest rates are likely to raise the real cost of borrowing and act to slow the economy.

Kenya posted a record trade deficit in 1978.

Kenya's external accounts deteriorated sharply in 1978; lower coffee and tea prices trimmed export receipts 16%, while import payments climbed 42%. The record imports resulted from significantly higher defense outlays and expanded domestic demand in the wake of the 1977 coffee and tea boom. Kenya's current account swung from a $57-million surplus in 1977 to a $636-million deficit last year, paralleling an unprecedented $645-million trade gap. Foreign reserves fell 32% to $365 million over the same period. Credit restrictions and import controls intended to redress the deterioration in the foreign accounts will have only a moderate impact this year, as imports—80% of which consist of petroleum and capital goods—are of limited compressibility. Moreover, coffee earnings are expected to fall 25%-30% because of lower prices and rain-damaged crops. Thus, substantial trade and current-account shortfalls in the $500-$550-million range appear likely, auguring continued belt-tightening policies into 1980.

Afghanistan's economy weakened by political disruption.

Afghanistan's trade deficit is expected to worsen in the current fiscal year. Nearly all of the country's exports are agricultural commodities or processed agricultural goods, and the Government's recently-completed land reform program—combined with political disturbances in rural areas—has disrupted agricultural production. On the import side, low rainfall has hurt this year's wheat crop, necessitating a high level of wheat imports to meet domestic consumption requirements. Import growth of intermediate and capital goods has slowed, however, as progress on development projects has been hindered by political disruption and related transportation problems. Overall, the Afghani trade deficit is expected to widen to over $100 million in fiscal 1979/1980 from about $80 million last year. The larger trade deficit, coupled with both a significant drop in foreign-exchange remittances associated with the expulsion of Afghani workers from Iran and reduced tourism earnings, also promises a higher current-account gap this fiscal year.

Cobalt prices have quadrupled since 1977.

The price of cobalt, a metal essential to the production of jet engines, has more than quadrupled over the last two years. Contributing factors have included: (1) strong demand for aircraft and capital goods; (2) supply disruptions in Zaire, the source of one-third of world output; (3) the late-1976 cessation of U.S. strategic stockpile sales, which had contributed 30%-40% to market supply; and (4) depressed conditions in the markets for copper and nickel, from which cobalt is mined as a by-product. Sharply higher prices have spurred efforts to boost supply; these include increased scrap recovery in the United States where there is no mine production. Efforts to develop substitutes have also been stepped-up. The official producer price for cobalt since last February has been $25 per pound, versus only $6.40 in early 1978, and free-market prices were as high as $43 per pound earlier this year before additional supplies brought prices back to their current level of around $27. Barring further disruptions in Africa, market conditions should continue to ease as the U.S. recession spreads to the capital equipment industries. But the extent of any price weakness will be limited by the desire of the United States and other countries to increase stockpiles.

The Fed's Wait-and-See Stance

The Federal Reserve appears to have established the target for the Federal funds rate at around 11½% to 11¾% for the time being. (The brief spurt in the rate at the end of last week was considered temporary and technical.) The sustained rise in the Federal funds rate, which began in mid-August, totaled about 75 basis points. During the past six weeks, the Fed's discount rate was increased to 11%, and short-term money market rates such as bank CDs and commercial paper rose around 150 basis points. The sharper advances in these latter rates, of course, reflected pronounced shifts in expectations about the course of interest rates in coming months. During much of the late spring and early summer, 90-day CD and paper rates were 50 basis points or so *below* Federal funds. At their recent peaks they were about 25 points *above*, but subsequently spreads narrowed to around 10 points.

Indications that the Fed intended to maintain the Federal funds rate in the vicinity of 11½% came from money market intervention patterns several days after the September 18 meeting of the Federal Open Market Committee. Indeed, market expectations of such action were spurred by the Federal Reserve's announcement on September 19 of the discount rate increase from 10½% to 11%. There had been some anticipation the increase would be larger, possibly to 11½%, in which case the Federal funds rate would have been pushed higher as well. As it was, however, three of the seven Federal Reserve governors dissented from the 11% action, preferring instead to stay at the previous 10½% level. This manifestation of strong differences of view within the Fed regarding near-term policy suggests a somewhat more cautious approach at this time by the Fed to further interest rate increases.

The anticipation that Federal Reserve policy will take a "wait-and-see" stance in the near term rests on at least four assumptions about monetary and economic conditions: First, the accelerated growth of M_1 and M_2 in the third quarter—10% and 12¾% respectively—will not carry into the fourth; nor will the Fed seek to offset that bulge with a new below-trend operating target. Second, the downward trend of U.S. output will continue, generating strong advances in the unemployment rate. Third, although the inflation rate may not improve much for several months to come, it will not get worse. And finally, while the dollar may be assumed to remain under some pressure, foreign-exchange markets will remain relatively orderly. In short, near-term Federal Reserve policy is expected to be reactive to any developing problems, rather than preemptive. Along this line, however, it is premature to contemplate the Fed easing interest rates. In fact, during the next month or two, rates are considerably more likely to go higher than lower.

Federal Deficit Still a Question Mark

As fiscal 1980 gets under way, the ultimate size of the 1980 Federal budget deficit is still an open question. When the budget was first introduced in January, the President proposed a deficit of $29 billion, the result of planned outlays of about $532 billion and expected receipts of $503 billion. Now that the budget process has worked its way through Congress, which has upped both the revenue and expenditure targets by some $16 billion each, it still appears that the projected deficit will be around $30 billion. However, the entire debate over the projected deficit may become academic if the economy behaves much differently from what Congress expects.

When the Administration prepared the budget, it included certain economic assumptions in its anticipations of revenues and expenditures. Critics in Congress and in the economics profession questioned these assumptions as overly optimistic, since the projections failed to take into account the possible severe downturn or recession that many forecasters were predicting. Since that time, Congress has adopted a more realistic forecast of the economy in 1980. The current version of the budget that has survived the Congressional debate is based on these assumptions. However, many economists still find the projections overly optimistic and expect the recession to push the deficit well above $30 billion.

A recession usually serves to widen the Federal budget deficit in two ways. First, tax receipts fall short of projections because of declines in business activity and the reduced rate of growth of personal income. Second, Federal transfer payments expand as the rate of unemployment rises. Inflation, on the other hand, can have the opposite effect. As it increases nominal personal incomes, it also pushes taxpayers into progressively higher tax brackets. As a result, personal income tax receipts tend to grow faster than the rate of inflation when tax rates remain unchanged. Government expenditures, however, show no necessary tendency to outpace inflation. During fiscal 1979, for example, the Consumer Price Index rose by about 12%; Federal revenue, however, climbed by almost 16%, while expenditures grew by only about 10%. In fiscal 1980, expenditures are estimated to grow at about the same rate. But the deficit will rise because recession will weaken receipts more than inflation stimulates them.

One result of the inflation-induced rise in personal income tax collections is the increased likelihood of a cut in tax rates. The ratio of personal tax payments to personal income has climbed to about 15%—the level that typically precedes a tax cut. Further favoring a tax reduction are the downturn in economic activity, which has turned Congressional attention toward fiscal stimulus, and the impending hike in the Social Security payroll tax scheduled for January 1980. Any tax cut, of course, further increases the probability that the fiscal 1980 deficit will exceed $30 billion.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1978		BALANCE OF PAYMENTS					MONEY AND BANKING							COUNTRIES
											12-month changes							
		3-months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves in millions of dollars	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars	current monetary conditions	
																September 26, 1979			
Austria	Economic growth strong; schilling revalued to reduce inflation.	Feb.	+ 5.5%	42.1	+ 1.5%	July	4,824	— 4.1%	3.3	0	Current-account deficit in first half below year-earlier level.	June	+ 3.2%	Apr.	+15.0%	3.75%	.0785	Rates firm following schilling revaluation.	**Austria**
Belgium	Growth rate of 2.5% officially forecast for 1980, along with rise in inflation rate to 6%.	May	+ 9.1%	68.2	+ 1.6%	July	7,327	+ 33.2%	1.7	0	Heavy government borrowing abroad covers current-account deficit.	July	+ 4.8%	Mar.	+11.1%	9.00%	.035236	Rates remain high with franc under pressure in EMS.	**Belgium**
Britain	Gradual economic slowdown apparent following spring peak.	July	+ 4.3%	245.6	+ 3.2%	July	21,073	+ 19.9%	3.0	1,138	First-half current-account gap tops $4 billion, despite North Sea oil sales.	Aug.	+15.8%	Mar.	+ 4.7%	14.00%	2.1930	Interest rates remain high.	**Britain**
Denmark	Growth slowing, but high oil prices boost pace of inflation.	Mar.	— 2.8%	41.0	+ 1.0%	July	3,993	+ 34.5%	3.0	0	January-July trade deficit of kr. 11.5 billion, vs. kr. 8.5 billion last year.	June	+ 8.6%	May	+ 4.2%	11.00%	.1932	Discount rate raised to 11% to bolster kroner in EMS.	**Denmark**
Finland	GNP growth rate expected to be very high in 1979.	Apr.	+ 6.7%	27.5	+ 2.5%	May	1,676	+ 57.5%	2.4	131	January-July trade surplus of 1.09 billion markkaa, vs. 1.07 billion year-earlier.	June	+ 7.2%	Feb.	+ 5.7%	7.25%	.2660	Rumors of revaluation persist.	**Finland**
France	Commitment to current anti-inflationary policies remains fragile, despite domestic activity.	June	+ 4.8%	377.1	+ 3.3%	June	19,066	+ 64.6%	2.5	0	Current-account to remain in small surplus, despite growing trade deficit.	Aug.	+10.8%	Dec.	+12.4%	9.50%	.2422	Interest rates rise to support the franc.	**France**
Germany	First-half real GNP up 4.3% above year-earlier; growth set to weaken.	July	+ 7.6%	469.1	+ 3.1%	July	53,007	+ 29.0%	4.1	0	Current-account moves into deficit as trade surplus is sharply reduced.	Aug.	+ 4.9%	Apr.	+12.9%	5.00%	.5680	Speculative inflows lead to DM revaluation.	**Germany**
Ireland	Despite slowing growth, GDP growth remains highest of EEC countries.	Jan.	+ 5.2%	9.4	+ 7.0%	July	2,182	+ 3.3%	3.2	0	Trade figures remain weak, but offsetting capital inflows maintain reserves.	May	+ 12.4%	July	+35.8%	13.70%	2.1075	Interest rates remain at near-record levels.	**Ireland**
Italy	Strikes depress output somewhat, but demand still strong; 4.5% growth expected in 1979.	June	0	194.4	+ 2.6%	July	21,498	+ 58.7%	4.0	342	Drop in current-account surplus expected, despite strong tourist receipts.	Aug.	+15.5%	Dec.'78	+11.2%	10.50%	.001235	Lira remains buoyant in EMS.	**Italy**
Netherlands	Economy buoyed by fast German growth, but slowdown expected next year.	May	+ 2.8%	90.9	+ 2.5%	July	9,549	+ 19.8%	2.0	0	Oil price rise boosts value of gas reserves.	July	+ 3.7%	May	+18.5%	8.00%	.5135	Credit conditions moderately restrictive.	**Netherlands**
Norway	Anti-inflationary policies have reduced year-on-year price increases to 4.4%.	June	+ 4.1%	32.4	+ 3.5%	July	3,962	+ 21.3%	4.1	0	First-half trade deficit of kr. 3.35 billion, about half year-earlier gap.	July	+ 4.8%	May	+15.1%	7.00%	.2018	Central bank moves to tighten credit.	**Norway**
Portugal	Parliament approves escudo 20-billion increase in budget deficit.	Dec.	+ 4.6%	17.1	+ 3.2%	June	1,620	+ 29.7%	3.8	240	Talks resumed with IMF regarding $50-million loan.	June	+30.3%	Mar.	+19.6%	18.00%	.0210	Interest rates maintained at high level.	**Portugal**
Spain	Medium-term economic plan cuts 1979 GDP growth target to 2.5%.	June '78	+ 5.4%	110.7	+ 2.9%	Apr.	11,724	+ 54.8%	6.8	267	Reserve position continues to strengthen, reaching record level.	May	+15.6%	May	+15.5%	8.00%	.0153	Tight money policy continues to restrain credit demand.	**Spain**
Sweden	Formulation of economic policy delayed by inconclusive election results.	May	+ 5.7%	70.2	+ 2.8%	July	4,008	— 10.5%	2.0	0	Jan.-Aug. trade gap of kr. 2.8 billion, vs. kr. 3.1-billion surplus year-earlier.	July	+ 6.6%	Apr.	+21.7%	8.00%	.2412	Measures to limit monetary growth taking effect.	**Sweden**
Switzerland	Growth expected to weaken, but outlook for inflation improves.	Mar.	+ 2.9%	55.2	+ 0.9%	July	17,558	+ 37.2%	7.9	0	Trade deficit for first half tops SF 1.5 billion.	Aug.	+ 4.0%	Apr.	+ 9.7%	1.00%	.6365	Authorities unwilling to tighten monetary policy further.	**Switzerland**
Turkey	New agreement with IMF signed; monetary and fiscal policy to be tightened.	May	+ 4.7%	40.7	+ 3.2%	July	1,490	+ 53.3%	3.8	678	Foreign-debt renegotiations end; foreign-exchange crisis eases somewhat.	Mar.	+38.2%	Nov.	+33.7%	10.00%	.0275	Credit conditions restrictive.	**Turkey**
Canada	Economic growth slowing because of trade effects of U.S. recession and inflationary pressures.	June	+ 3.1%	184.6	+ 3.4%	July	4,239	— 7.7%	1.0	0	Decline in long-term capital inflows.	Aug.	+ 8.4%	Apr.	+21.0%	12.25%	.8563	Central bank and prime rates raised.	**Canada**
United States	Accumulating inventories result in August production declines and increased unemployment.	Aug.	+ 2.3%	1,754.9	+ 4.0%	July	20,903	+ 8.0%	1.3	0	Current-account improvement expected in 1980, despite higher oil bill.	Aug.	+11.8%	Aug.	+13.1%	11.00%	—	Fed maintains tight money policy.	**United States**

World Interest Rates

market rates as of September 26, 1979; bond yields as of September 21, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	12.25	14.00	9.00	9.50	5.00	10.50 penalty rate 13.50	8.00	1.00	5.25
Day-to-Day Money	11.6875 Sept. 27	11.50	13.625	11.35	11.50	5.00	11.50	8.75	0.375	7.00
Treasury Bills 91-day, Middle Rates	10.20	11.55	14.375	12.50 120-day	12.16 one year	n. a.	10.50 94-day	no dealing	no market	5.125 2-month
Commercial Paper prime, 3-month, asked	11.50 finance paper	12.00 finance paper 15% tax w/h	12.66 H. P. on discount basis	8.90 Certified	11.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.55	11.90 15% tax w/h	14.00	11.00 Certified	not traded	7.40	12.625	no market	3.00 not traded	no market
Government Bonds Long-term, new and old issues, average yield	9.11	10.75	12.34	9.17 20% tax w/h	10.74	7.52	13.21	8.77	3.52	7.59
Industrial Bonds prime, long-term, new and old issues, average yield	9.85 Aa Industrials	11.125	12.79	11.90 20% tax w/h	11.95	7.83	13.42	9.26	4.36	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	13.25	13.00	15.00	13.00	10.10	7.25	15.50	11.00	4.00	5.50
Bank Time Deposits 3-month	11.50 Cert. of Dep.	12.00 Cert. of Dep.	14.0625 Cert. of Dep.	12.50	11.75	7.75	8.50	10.125 large deposits	1.75 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	12.50	no market	14.0625	no market	13.125	7.3125	no market	9.375	1.5625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8563	2.1930	.035236	.2422	.5680	.001235	.5135	.6365	.004497
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.625 *P*	1.625 *D*	1.00 *D*	.50 *D*	5.00 *P*	2.50 *D*	3.00 *P*	11.00 *P*	5.00 *P*

Eurodollar Deposits
(London, interbank, bid)
September 27

7-day	11.875
1-month	12.125
3-month	12.625
6-month	12.625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.35
U.S.-Canada Treasury Bills	−1.50
U.S.-Canada Finance Co. Paper	− .96
Eurodollars-U.K. Local Auth. Deposits	+ .13

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	10.25
Over 7 yrs.	10.25
DM Bonds	
7 yrs. and under	7.00
Over 7 yrs.	7.35

Gold Price
London afternoon fixing
373.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	11.8 (Aug.)	8.4 (Aug.)	15.8 (Aug.)	10.8 (Aug.)	4.9 (Aug.)	15.5 (Aug.)	4.0 (Aug.)	4.2 (July)
Industrial production*	2.0 (Aug.)	2.4 (July)	4.3 (July)	4.8 (June)	7.6 (July)	3.7 (July)	3.0 (June)	9.4 (July)
Trade balance† *(billions of local currency units)*	−$2.36 (Aug.)	C$0.08 (July)	−£0.10 (Aug.)	FF3.17 (Aug.)	DM0.98 (Aug.)	−Lt388 (July)	−SF0.59 (July)	−¥140 (Aug.)
Money supply (M_1)*	4.9 (Aug.)	6.3 (Aug.)	12.4 (July)	12.3 (July)	11.1 (Aug.)	23.2 (Apr.)	9.0 (June)	11.1 (Aug.)
Velocity of money (M_1)*	6.6 (June)	6.3 (Mar.)	4.0 (Dec.)	n. a.	3.1 (Mar.)	5.6 (Dec.)	n. a.	−4.0 (Mar.)
Reserves *(millions of U.S. $, end of period)*	20.903 (July)	4.239 (July)	21.073 (July)	19.066 (July)	53.007 (July)	21.498 (July)	17.558 (July)	25.379 (July)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Soviet and East European Debt Perspectives

After having succeeded in steadily paring down their combined hard-currency trade deficit from $12 billion in 1975 to $7 billion in 1977, the Soviet Union and its East European partners in the Council for Mutual Economic Assistance (CMEA) saw their hard-currency trade balance worsen last year. Despite continued efforts to bring trade with the West into balance, the combined deficit of the Soviet Union and the East European countries grew by $1.8 billion to $8.8 billion in 1978.

The Soviet Union suffered the worst setback, with a $1.9-billion rise in its hard-currency trade gap to $3.4 billion. Hungary's deficit widened by $460 million to $825 million and Romania's increased by $250 million to $700 million. Bulgaria and the German Democratic Republic were able to stabilize their hard-currency deficits close to their 1977 levels, at $235 million and $1.4 billion respectively. The only two countries that recorded slight improvements in their hard-currency balances were Poland and Czechoslovakia. Poland cut its deficit by $375 million to $1.8 billion, and Czechoslovakia reduced its shortfall by $186 million to $400 million.

Reduced CMEA-country growth rates, particularly in the agricultural sectors, resulted in supply shortfalls that had to be made up by increased imports. At the same time, the slowdown in economic growth has for the most part blocked achievement of planned export growth targets. Prospects for an improvement in the CMEA's hard-currency trade balance this year appear slim. Although the 1979 plans set more realistic production and investment target growth rates, the first-half-year results indicate that some countries may be hard put to achieve even the more modest growth targets. Preliminary projections point to an overall CMEA hard-currency trade deficit in the $8.5-$9-billion range in 1979.

The CMEA's net hard-currency debt (drawings on medium- and long-term official Western export credits, supplier credits, and liabilities to Western banks, less reserves held on deposit with the banks) grew by 17% last year to an estimated $60.7 billion (see table). The estimated net debt exposure for individual countries in 1978 was as follows: Soviet Union, $17.2 billion; Poland, $16.8 billion; German Democratic Republic, $8.2 billion; Hungary, $5.7 billion; Romania, $4.4 billion; Bulgaria, $3.4 billion; Czechoslovakia, $2 billion; and the two CMEA banks—the International Investment Bank (IIB) and the International Bank for Economic Cooperation (IBEC)—$3 billion.

The largest part of the overall CMEA debt in 1978—about 58%—was owned to Western commercial banks; official Western export credits accounted for some 38% of the total CMEA debt, and supplier credits, for about 2%.

The proportions of CMEA debt sources vary from country to country. In the case of the Soviet Union, Western official credits accounted for 70% of its total debt while the commercial banks' share of the Soviet debt was 26%. For the other countries the proportions were reversed—commercial bank credits accounted for 50% to 80% (in the case of Hungary, 98%) of their total debt, while the share of official credits ranged from 20% to 36%.

Of the estimated $23 billion in outstanding official Western export credits, the Soviet Union's share was a little over 50%. Poland was next, with 23% of the total. France, Germany, Japan, Britain, Italy, and Austria were among the major Western suppliers of these official credits.

The CMEA's net liabilities to Western banks rose by $7 billion to $37 billion at end-1978. The individual country breakdown shows Poland with the largest net exposure to the banks ($10.9 billion), followed by Hungary ($5.5 billion), the German Democratic Republic ($5 billion), the Soviet Union ($4.5 billion), Bulgaria ($2.7 billion), Romania ($2.3 billion), and Czechoslovakia ($1.4 billion). The estimated net lia-

CMEA External Debt Summary: End-December 1978

($ million)

	Soviet Union	Eastern Europe	IIB, IBEC
Estimated outstanding official export credits	12,200	10,828	—
Outstanding supplier credits[1]	500	1,000	—
Net liabilities to Western banks[2]	4,463	27,791	3,000
Outstanding IMF, IBRD credits[3]	—	916	—
Total Net Debt	17,163	40,535	3,000

1) A forfait obligations.

2) Banks in the Group of Ten countries, Switzerland, Austria, Denmark, Ireland, and offshore branches of U.S. banks in the Bahamas, Cayman Islands, Panama, Hong Kong, and Singapore.

3) Applies to Romania—$366 million in IMF drawings and $550 million in outstanding World Bank loans.

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bilities of the two CMEA banks to Western banks totaled $3 billion.

About 45% of the CMEA's total net debt to Western banks was owed to British-based banks—$17 billion at end-1978. Claims of U.S. banks (both domestic and foreign offices) on the CMEA stood at $5.7 billion at end-1978, accounting for about 12% of total Western bank claims on the area and a little over 2.5% of U.S. banks' global claims.

The maturity distribution of the CMEA countries' liabilities to Western banks shows that 40% of total CMEA liabilities of $47.6 billion at end-1978 were short-term—up to one year. Outstanding loans with maturities of over two years accounted for 30% of the total and those of one to two years, for 10%. Undisbursed credit commitments to the CMEA at end-1978 covered about 25% of total outstanding loans.

The share of Eurocurrency balances in the CMEA's total net liabilities to the banks rose by $3.9 billion during the year to $22.6 billion at end-1978. Borrowings on the Eurocurrency market accounted for 65% of the CMEA's liabilities to the banks—$31 billion at end-1978. During 1978, the CMEA raised a total of $3.7 billion in publicized medium-term Eurocurrency credits, close to the 1977 level of $3.4 billion. The volume of medium-term Eurocurrency loans raised by the CMEA during the first eight months of 1979 reached $2.5 billion.

In absolute terms, the magnitude of CMEA overall external indebtedness is not alarming since it is the world's second largest industrial growth area. It is also not surprising that about 70% of the overall CMEA debt is concentrated in three countries—the Soviet Union, Poland, and the German Democratic Republic—which are the most industrially advanced.

The overall CMEA debt-service cost (repayments on principal and interest payments on medium- and long-term debt) reached $12 billion during 1978. In 1979, the area's debt-service cost is expected to reach a level of about $14 billion.

The non-merchandise trade earnings of the six East European countries, estimated at about $2 billion, was more or less sufficient to cover interest payments. Non-merchandise earnings of the Soviet Union, estimated at over $3½ billion, were far in excess of its interest payments.

The aggregate CMEA debt-service ratio (repayments of principal and interest payments on medium- and long-term credits as a percentage of hard-currency merchandise exports) was 39% in 1978 and is expected to breach the 40% level in 1979. The Soviet Union's 26% debt-service ratio was the lowest in the area, and Czechoslovakia's 28% was the second lowest. Bulgaria and Poland were the two countries with the highest debt-service ratios—both above 60%. The debt-service-ratio levels of Romania, the German Democratic Republic, and Hungary were in the 35%-40% range.

Each country has a distinctive approach to debt management. Self-liquidating credit arrangements with Western capital goods suppliers are the linchpin of the Soviet Union's debt-management policy. Better known as compensation deals, such arrangements involve purchases of Western plant and equipment and technology with payment in Soviet products. Compensation deals account for over 35% of the Soviet Union's overall debt.

Soviet officials claim that there are more than 60 projects at various stages of development in the Soviet Union that are based on compensation arrangements with Western equipment and technology suppliers. Estimates of hard-currency earnings to be generated through these deals in the period 1981-1985 range between $14 and $16 billion.

The energy crunch

For the East European countries, the rising cost of energy imports is a pressing problem. The burden of escalating costs of Soviet oil and natural gas deliveries, under the new pricing formula introduced in 1975, will limit their ability to divert available resources to boost exports to the West. Since the adoption of the new pricing formula, designed to bring intra-CMEA prices closer to world levels over a period of five years, the terms of trade of the six East European CMEA members versus the Soviet Union have been deteriorating because of their heavy reliance on Soviet raw material and energy supplies.

The combined cost of Soviet oil and gas deliveries to the East European countries in 1978 rose by more than $1 billion to an estimated $7.7 billion. This includes some Soviet crude oil supplies sold to East European buyers over and above contractual quotas at world prices. This year, further price increases will result as a partial adjustment to the sharp rise in world oil prices.

Soviet oil and gas exports to Western industrialized countries and to the developing nations accounted for a little over 60% of its total hard-currency exports valued at $13.2 billion in 1978. There appears to have been no increase in the volume of Soviet oil exports to non-Communist countries (the Soviets stopped publishing tonnage statistics) so that the increase in the value of their oil exports was made up by higher prices. On the other hand, exports of Soviet natural gas have increased in volume under existing long-term contracts.

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